Opinion of the District Court.

The grounds of the decision in the District Court are succinctly shown in the following extracts from Judge Rellstab's opinion:

> "The government contends that the legal reserve of a mutual insurance company cannot be its invested capital, because it does not belong to it, but to the policy holders; that such fund is in the nature of a trust fund, and is in fact a liability, and not an asset. For some purposes this reserve is a liability, or a trust fund; but so is the capital subscribed by shareholders in a stock corporation. Both are treated as a liability in balancing assets and liabilities. In the case of an insolvent stock corporation, its assets are charged with a trust in favor of creditors. On the dissolution or liquidation of a stock corporation, the capital remaining after the payment of debts belongs to the shareholders. So, on the dissolution of a mutual insurance company, the holders of unmatured policies, after the payment of matured policies, share pro rata the assets of the company, including the legal reserve. Mayer *v.* Attorney General, 32 N. J. Eq. 815, 822. If the legal reserve of a mutual life insurance company is a liability or trust fund in favor of the policy holders, as the government contends, so are the other assets of the company. The difference between them is merely that the former is required by law to be maintained intact as a guaranty for the payment of such policies, and cannot lawfully be diverted to other uses" (R. 25-26).

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"An examination of the returns made by the plaintiff for the years 1911 to 1917, inclusive, for federal income tax purposes, discloses that while both its gross income and expenditures steadily increased, the increases were quite conservative, the average increase from 1913 being less than 7 per cent. The return for 1918, on the contrary, shows that, while the gross income increased at about the same rate, the increase in expenses over 1917 exceeded 12 per cent. While the end of military operations in 1918 necessarily limited the scope of the comparison for this purpose, yet even this short period confirms the concept that a life insurance company is more likely to lose than gain during a war period—more likely to have excessive losses than excessive profits. None of the plaintiff's assets during 1917 yielded a greater income than 6 per centum per annum, and the average rate of interest or return on its invested assets for many years was less than that percentage" (R. 29).

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"In amending the plaintiff's excess profits tax return, the Commissioner, applying section 203 (a), above, allowed only $9,657,529.56 as its average invested capital for the pre-war period, and calculated its average taxable income for such period at $869,678.46 or 9.005 per cent. In computing this average he refused to allow any of the legal reserve as part of the invested capital for the pre-war period, and in fixing such capital for the year 1917 he, of course, adhered to the same ruling, with the result that, as before stated, the invested capital for that year, as computed by him, was reduced from $202,685,846.45 to the sum of $14,719,043.76. This sum is less than $5,000,000 more than the total income received from the actual invested assets for that year; such income

equaling 67.42 per cent. of the amount allowed as invested capital. As noted, so much of this reserve as was not interest from invested assets was obtained from the members of the corporation—policy holders—in the shape of premiums. These premiums were deliberately made larger to permit of a part being applied to the legal reserve. By such contribution the plaintiff's only capital fund was created and maintained. Without such redundancy of premiums the plaintiff could not have either complied with the statute requiring such reserve, or produced the nearly $10,000,000 interest which swelled the income on which it paid a federal income tax.

"To tax the income derived largely from an invested fund and deny that the fund is invested capital is neither logical nor consistent, and such a result should not be allowed, unless the statutory definition permits of no other course. This the government does not dispute" (R. 31).

* * * * * *

"The government concedes that all the plaintiff's assets, over and above the legal reserve, are invested capital within the meaning of such section, and the Commissioner's determination that the plaintiff had $14,719,043.76 as invested capital is based on such concession. It insists, however, that this sum embraces all the assets of plaintiff that fit in with the terms of subdivision (3), par. (a), of that section, and that that is the only subdivision which could be made applicable to such company.

"To my mind, the Commissioner's segregation of the plaintiff's assets into legal reserve and surplus is unsubstantial, and his determination that only the surplus constitutes the statutory 'invested capital' is erroneous. Such a ruling, as pointed out by the plaintiff, would produce strange results. The

company which kept its premiums closest to the mathematical computation of cost would have the smallest surplus—Commissioner's invested capital—the largest earnings pro rata, and pay the largest excess profits tax, while the company which secured the largest surplus through a liberal loading of the premiums would obtain the smallest earnings pro rata and pay the smallest excess profits tax. In the absence of compelling reasons, such an incongruous and inequitable result is not to be imputed to Congress. I fail to see how this so-called surplus of the plaintiff's assets may be held to be invested capital, as paid-in or earned surplus or undivided profits used or employed in the business, if the legal reserve is not. True, the legal reserve is required by law, while the other assets are not so required, and the company has less control over the disposition of the legal reserve than over its remaining assets. But these facts furnish no basis for excluding the former from, and including the latter in, 'invested capital.' Both have a common source, namely, premiums paid in by the policy holders and income derived from investments. So much of each of these classes of assets as represents premiums, is actual cash paid in to the insurance company by its members. These members—policy holders—are analogous to shareholders in a stock corporation. Subdivision (1), par. (a), of section 207 of the Revenue Act of 1917 is not expressly restricted to cash paid for shares of stock, and if mutual insurance companies are to be subjected to the imposition of war excess profits taxes, then by analogy so much of the premium payments made by such members, which is in excess of the actual cost of the insurance, should be held to come within such subdivision and be treated as 'invested capital' " (R. 33-34).

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"The individual premiums paid by a policy holder of a mutual life insurance company, as already stated, being intentionally made larger in amount than supposed to be necessary to defray the actual cost of insurance, it follows that they cover more than protection. Included therein is something for investment, differing radically in this respect from premiums paid for fire, marine or casualty insurance. Penn Mutual Co. *v.* Lederer, 252 U. S. 523, 533, 534, 40 Sup. Ct. 397, 64 L. Ed. 698. This portion paid as investment is retained by the company, and so much thereof as is added to legal reserve so continues until the policy matures or is surrendered. No dividends are paid out of this reserve during the continuance of the life of the policy, for it is kept invested and reinvested to mature the outstanding policies. It, as well as its increment, inures to the benefit of the policy holders, and this reserve, at all times while in the possession of the company, is capital invested or held for investment" (R. 35).

Opinion of the Circuit Court of Appeals.

The Circuit Court of Appeals affirmed upon the opinion of Judge Rellstab (3 Fed. (2d) 1020).

Summary of Argument.

First. The assets of a mutual life insurance company owned and held for investment in the business, as well as for protection, which are in fact invested capital, are not excluded by the statute from being treated as such.

Second. The legal reserve of a mutual life insurance company consists of assets contributed by the members of the corporation for investment as well as protection, to-

gether with assets earned on such investment and reinvested. These assets, invested in the business and forming the basis of the enterprise, are in fact, and under the statute, invested capital. The reserve is not an indebtedness.

(1) The title to the assets which are equal to, or are said to compose, the legal reserve is in the corporation.

(2) The legal reserve is not "money or other property borrowed."

(3) The fact that the reserve in question is required by law does not alter the quality of the assets which compose it.

(4) The legal reserve is not an indebtedness.

(5) The fact that several States, including New Jersey, tax life insurance companies only on the excess of their assets over their legal reserves does not make these reserves an indebtedness.

(6) The legal reserve is not a trust fund.

Third. The assets equal to, or composing, the legal reserve are not within the non-inclusion clause of the statute.

Fourth. The Government's claim is not aided by the capital stock tax act of 1916, but, on the contrary, the provisions and policy of that act support the respondent's contention.

Fifth. There is no distinction, in respect to the question here involved, between the reserve of a life insurance company and that of a fire, marine or casualty company.

Sixth. Statements made in the course of hearings before the Committees of Congress are immaterial.

ARGUMENT.

FIRST. The assets of a mutual life insurance company owned and held for investment in the business, as well as for protection, which are in fact invested capital, are not excluded by the statute from being treated as such.

The tax was laid under the provisions of Title II of the Act of October 3, 1917, imposing an excess profits tax (R. 5). The declared policy of this Act was to reach excessive profits made during the war. The Finance Committee of the Senate reported (Report of August 6, 1917, 65th Cong. 1st Sess., Sen. Rep. No. 103, pp. 3 and 4):

> "After mature consideration your committee reached the conclusion that, in view of the large amount to be raised and the enormous war profits, amounting to nearly $3,000,000,000, shown by the income-tax returns of corporations for 1916, which amount will undoubtedly be increased for the year 1917, due in the main to war and war conditions, $562,000,000 was not an unreasonable additional amount to ask *from the industries whose earnings have been so greatly augmented* by the conditions which made necessary the call for this additional revenue.
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> "Your committee accordingly proposes the repeal of the existing war-profits tax law, and the substitution for both it and the additional war-profits tax passed by the House of a tax upon a basis similar to that followed by the European countries in which such taxation has been carried out with marked

> success. The committee proposes, instead of an *excess*-profits tax, a *war*-profits tax. In general, it proposes to make the basis of the tax the difference between the profits of the pre-war period and the profits of the taxable year. We take by taxation, directly or indirectly, for the purposes of war, a part of the *extra gains which war itself has caused.*" (Italics ours).

This purpose was attributed to the law by this Court in *La Belle Iron Works* v. *U. S.*, 256 U. S. 377, 386, as follows:

> "Reading the entire language of Section 207 in the light of the circumstances that surrounded the passage of the Act, we think its meaning as to 'invested capital' is entirely clear. The great war in Europe had been in progress since the year 1914, and the manufacture and export of war supplies and other material for the belligerent powers had stimulated many lines of trade and business in this country, resulting in large profits as compared with the period before the war, and as compared with ordinary returns upon the capital embarked. The United States had become directly involved in the conflict in the Spring of 1917, necessitating heavy increases in taxation; at the same time manufactures and trade of every description were rendered even more active, and in certain lines more profitable, than before, *so that the unusual gains derived therefrom formed a natural subject for special taxation.*" (Italics ours.)

It was necessary, however, in order to impose the desired tax on "excess profits" due to war conditions, to provide for a calculation of pre-war profits, and to exempt

what was deemed to be a fair equivalent. Such a calculation could not be made without taking into account the rate of return on the amount invested in the business, that is, invested capital. The foundation of the tax was not profits *per se*, but profits in relation to capital, and excess profits in the light of this relation. It was plainly in pursuance of this policy that the Congress defined invested capital. The definition of invested capital was not intended to be artificial or arbitrary but to allow what could reasonably be considered as the amount invested in the business.

The Government concedes that the respondent had "invested capital". The question is not whether a mutual life insurance company (without capital stock) can have "invested capital" under the statute, but of the way in which it should be computed. The Government assessed the tax in question upon the basis that the plaintiff *had* "invested capital", but computed this capital at only $14,719,043.76 (R. 5), ignoring other assets of the plaintiff actually held for investment and which produced the income upon which the tax was laid.

The Government, then, is not in a position to contend that a mutual life insurance company is outside the policy of the definition of invested capital in Section 207 of the Act of October 3, 1917. If a mutual life insurance company, without capital stock, is within the provisions of this act, as the Government insists, it is equally within the clear policy of these provisions and is entitled to have its actual invested capital taken into consideration in considering what, if any, excess profits it had made.

The Government seeks to limit the application of Section 207 to mutual life insurance companies by insisting that the only invested capital they can have must come

under subdivision (3) of Section 207(a) which relates to "surplus and undivided profits".

In this way, the Government reduced the amount of invested capital owned and held at the beginning of the tax year, from $198,712,831.17 to $14,719,043.76. The Government, in effect, says that a mutual life insurance company can have undivided profits as "invested capital" (this being the theory upon which the tax was laid) but cannot have as "invested capital" that which has been contributed by the members of the corporation for the purpose of investment and which earns the profits.

The Government gets under way with its argument by summarily eliminating, with barely more than the mere statement (Govt's. Brief, pp. 14, 15), subdivisions (1) and (2) of Section 207 (a). The Government asserts that these subdivisions apply only to payments for capital stock and that as a mutual life insurance company has no capital stock, it can have no "invested capital" under subdivision (1) which expressly allows as invested capital "actual cash paid in".

This presents the first question. We shall consider later the status of the assets called the "legal reserve". The preliminary question is whether a corporation without capital stock can have "invested capital" consisting of "actual cash paid in" within the meaning of subdivision (1) of Section 207 (a). The Government asserts that it cannot. We submit that the Government's construction is inadmissible and would do violence to the terms and clear intent of the statute.

The Government bases its assertion on what was said by this Court in *La Belle Iron Works* v. *United States*,

supra, p. 388. But there the Court was dealing with a stock corporation. It did not have the present question before it and manifestly the Court was not attempting to make an exclusive statement, but a statement applicable to the case it was deciding.

The Government apparently overlooks the fact that the sections of the Act of October 3, 1917 relating to the excess profits tax, applied not simply to corporations but also to *partnerships and individuals.* The Congress allowed as a deduction a certain return "equal to the same percentage of the invested capital for the taxable year which the average amount of the annual net income of the trade or business during the prewar period was of the invested capital for the prewar period (but not less than seven or more than nine per centum of the invested capital for the taxable year)" (Sec. 203). For this purpose the Congress defined invested capital in Section 207 as follows:

> "Sec. 207. That as used in this title, the term 'invested capital' for any year means the average invested capital for the year, as defined and limited in this title, averaged monthly.
>
> "As used in this title 'invested capital' does not include stocks, bonds (other than obligations of the United States), or other assets, the income from which is not subject to the tax imposed by this title, nor money or other property borrowed, and means, subject to the above limitations:
>
> "(a) In the case of a *corporation or partnership*: (1) Actual cash paid in, (2) the actual cash value of tangible property paid in other than cash, for stock or shares in such corporation or partnership, at the time of such payment (but in case such tangible property was paid in prior to January first,

nineteen hundred and fourteen, the actual cash value of such property as of January first, nineteen hundred and fourteen, but in no case to exceed the par value of the original stock or shares specifically issued therefor), and (3) paid in or earned surplus and undivided profits used or employed in the business, exclusive of undivided profits earned during the taxable year * * * .

"(b) In the case of an *individual,* (1) actual cash paid into the trade or business, and (2) the actual cash value of tangible property paid into the trade or business, other than cash, at the time of such payment (but in case such tangible property was paid in prior to January first, nineteen hundred and fourteen, the actual cash value of such property as of January first, nineteen hundred and fourteen), and (3) the actual cash value of patents, copyrights, good will, trade-marks, trade brands, franchises, or other intangible property, paid into the trade or business, at the time of such payment, if payment was made therefor specifically as such in cash or tangible property, not to exceed the actual cash or actual cash value of the tangible property *bona fide* paid therefor at the time of such payment * * *" (italics ours).

It would seem to be clear that the Congress, while it prescribed certain limitations, had no idea of ignoring the real capital invested in the business. Corporations and partnerships are put in the same class in this respect. It is submitted that it would be quite inadmissible in giving a reasonable construction to these provisions, to hold that a corporation deemed to be within the Act, but having no capital stock, and having actual capital contributed by its members invested in its business, should be denied the right

to have that capital treated as invested capital when partnerships, without capital stock, and individuals, without capital stock, were entitled to have their contributions and actual capital so considered. It would be extraordinary, and it would seem to be wholly unreasonable, by virtue of such a construction, to reach the conclusion that the Act imposed a heavy war profits tax burden upon mutual life insurance companies whose investments never returned as much as six per cent. (R. 2) and on which it had made no war profits at all.

The definition of invested capital in Section 207, applying to corporations (save as excepted) without capital stock as well as to corporations with capital stock, applying to partnerships and individuals as well as to corporations, must be interpreted, we submit, as embracing cash contributions by members of mutual corporations for investment in the business, although there is no capital stock and no shares in the sense of stock or shares issued by corporations having capital stock. The excess profits tax Law was severe enough without construing it so as to justify arbitrary impositions outside the expressed intent of the Congress.

If the words "stock or shares" in subdivision (2) of Section 207 (a) could be regarded as qualifying the words "actual cash paid in" in subdivision (1) of Section 207 (a), is it not plain that these words must receive an interpretation broad enough to cover partnerships as well as corporations, and corporations without capital stock as well as with capital stock? They must receive an interpretation broad enough to carry out the policy of the Act which was intended to impose a like tax on individuals and allows to the individuals as investment in the business all cash actu-

ally paid in. Either (a) the Act does not apply to mutual companies without capital stock, or (b) the word "shares" must be taken to embrace the actual interests of the members in the assets of the corporation which are owned and held for investment in its business.

We submit that the foundation of the Government's argument, that, because the respondent had no capital stock, it can have no invested capital consisting of cash actually paid in by its members for investment, is unsound.

The Government refers (Govt's. Brief, p. 15) to the excess profits tax provisions of the Revenue Act of 1918 (Act of February 24, 1919, c. 18, sec. 326; 40 Stat. 1092). This case does not arise under that Act, and that Act cannot be regarded as an interpretation of the earlier Act of 1917 for a very simple reason.

The Revenue Act of 1918 constitutes a radical departure from the policy of the Act of October 3, 1917. By the Act of 1918, partnerships and individuals were no longer subjected to an excess profits tax. The new Act had a distinct policy and was confined to corporations (Regulations 45, Art. 701). The argument from the new Act so far as it relates to corporations is, indeed, against the Government's contention. We have seen what the words "stock or shares" must have meant under the prior Act, which applied these words to partnerships as well as to corporations, and to corporations without capital stock as well as to those with capital stock. The words "stock or shares" in the prior Act, as above stated, were not limited to stock or shares issued by corporations with capital stock. And if the words "stock or shares" in the new Act could possibly be taken to refer only to stock or shares issued by

a corporation having capital stock, this was manifestly a new policy. Such an Act cannot be treated as an interpretation of the former Act, but must be regarded as an amendment or change in the law. (*Provost* v. *United States*, 269 U. S. 443).

In the exceptions found in Section 207 of the Act of 1917, the Congress manifested no intention of excluding actual invested capital, the income of which was subject to taxation, for the purpose of determining excess profits during the war period, as compared with pre-war profits. The Congress excepted "assets the income of which is not subject to the tax" (Sec. 207, *supra*). This exception would seem to imply that the Congress intended to *include* assets held for investment in the business, the income from which *was* subject to the tax. The Congress excepted "money or other property borrowed" (Sec. 207, *supra*), but allowed the amount of cash paid in. Money *not* borrowed, representing an actual interest or investment in the business on which the tax income was earned, was not *excluded* but *included*.

"Surplus and undivided profits" are admittedly allowed as invested capital. But it would be incongruous to allow surplus and undivided profits and not to allow actual capital contributions by members of a corporation, having no capital stock, when it was through the investment of such contributions the surplus and undivided profits were earned. It would be wholly inconsistent with the policy and terms of the Act so to reduce "invested capital" by excluding such contributions, and thus artificially to increase profits to a high rate when in fact the return on the investment was less than six per cent. and the return had not at all been affected by war conditions.

The theory of the Government excludes all invested capital in the case of a corporation having no capital stock, unless it is surplus or undivided profits. As the corporation without capital stock makes its profits by investing its actual capital contributed by its members, the elimination of this capital investment in the calculation gives a small base and may, as in this case, vastly heighten the calculated rate of return, represented by net income which is actually earned by the real capital. Thus, in the case of a corporation without capital stock, but having investments of capital actually contributed by its members, a corporation with a relatively small surplus or undivided profits and thus presenting a small base for the calculation on the Government's theory, would have a relatively high excess profits tax, while a corporation of this character with a large amount of surplus and undivided profits would have a relatively low excess profits tax. The corporation might make only five per cent. on its actual capital invested in its business, but if the allowed invested capital was only the amount of its surplus and undivided profits, the less this amount the greater the excess profits tax.

Judge Rellstab pointed this out (R. 34; 295 Fed. pp. 890, 891). In referring to the case of a mutual life insurance company, he said:

> "The company which kept its premiums closest to the mathematical computation of cost would have the smallest surplus—Commissioner's invested capital—the largest earnings *pro rata*, and pay the largest excess profits tax, while the company which secured the largest surplus through a liberal loading of the premiums would obtain the smallest earnings *pro rata* and pay the smallest excess profits tax. In

> the absence of compelling reasons such an incongruous and inequitable result is not to be imputed to Congress."

Thus, if the invested capital of the respondent, on the Government's theory, that is, its undivided profits had been only $1,000,000, the net income (after deducting all that could be considered as earned on the eliminated amount of undivided profits) would still have been over $1,000,000, and the excess profits tax, on this theory, would have been calculated on the assumption that the company had earned more than 100 per cent. on its undivided capital. The company would have been made liable for an enormous excess profits tax under the higher brackets, which ran as high as sixty per cent. under the Act of October 3, 1917, on the excess profits over thirty-three and a third per cent. of the calculated "invested capital" (Sec. 201).

We submit that the fair construction of Section 207, in its application to corporations having no capital stock, is to permit actual contributions by members for investment and mutual profit, the actual cash paid in for this purpose by the members, not being borrowed money or assets the income from which was not subject to the income tax, to be treated as "invested capital" and on this basis to determine whether excess profits have been made during the war period, and presumptively due to war conditions, as compared with the profits made during the pre-war period.

The question then is of the *character* of the assets in question which have been excluded by the Commissioner from the considerations in the calculation of the "invested capital" of respondent. It is inadmissible to say that if the assets have the character of capital, they must be ex-

cluded simply because a mutual life insurance company has no capital stock. It is inadmissible to say that the only "invested capital" such corporation can have must be found in "surplus and undivided profits". If the assets in question, which the Commissioner has excluded, were paid in by the members of the respondent for investment in the business and mutual profit, as well as protection, and are in truth capital, then it is submitted that there is no statutory ground for eliminating them from consideration in calculating the excess profits tax.

Not only does invested capital embrace, under Section 207, "actual cash paid in", that is the contributions which form the basis of the enterprise, but also "*paid in or earned surplus and undivided profits used or employed in the business,* exclusive of undivided profits earned during the taxable year". It clearly follows that the assets of a mutual life insurance company which consist of the amounts earned upon the contributions of the members, and which are owned and held for investment in the business, are not excluded by the statute from being treated as "invested capital".

On January 1, 1917, the respondent possessed, in addition to $70,000,000 of premiums paid in, about $116,000,000 of assets which represented the amount earned upon the Company's investments in previous years (R. 4). We find no suggestion in the Government's argument that a mutual life insurance company cannot have "earned surplus" used or employed in the business, or that it cannot have "undivided profits" used or employed in the business. Admittedly, these categories apply to mutual life insurance corporations. It is understood that even the Treasury Department has always considered that a mutual life insurance

company can have both "earned surplus" and "undivided profits". The question is simply as to the way in which earned surplus and undivided profits shall be computed. The contention is not that because a mutual life insurance corporation has no capital stock it cannot have both "earned surplus" and "undivided profits", but that it is not entitled to consider certain assets, upon which the income is earned, which the Government treats as subject to the tax, as coming within either category, although these assets are held for permanent investment and represent an increment gained through the investment of the members' contributions.

We repeat, then, that if the assets which the Government has excluded in its computation were held for investment in the business and mutual profit as well as protection, whether these assets consisted of the amounts originally contributed or were the result of the investment of these contributions, there is no statutory ground for refusing to consider them in calculating the excess profits tax.

SECOND. The legal reserve of a mutual life insurance company consists of assets contributed by the members of the corporation for investment as well as protection, together with assets earned on such investment and re-invested. These assets, invested in the business and forming the basis of the enterprise, are in fact, and under the statute, invested capital. The reserve is not an indebtedness.

Respondent conducts its business on the *level premium* plan, whereby during the policy period that part of the premium to be paid annually to meet death losses is an

average of the low natural premium in the early years and the high natural premiums in the later years of life, thus avoiding the necessity of prohibitive premiums as the probability of dying increases with advancing years.

The average premium so estimated, increased by an allowance for cost of conducting the business, is uniform throughout the life of the policy (R. 2, 3).

Mutual Benefit Life Insurance Co. v. *Herold,* 198 Fed. 199; 231 U. S. 755;
Penn Mutual Life Insurance Co. v. *Lederer,* 252 U. S. 523;
New York Life Insurance Co. v. *Styles,* L. R. 14 A. C. 381;
Connecticut General Life Insurance Co. v. *Eaton,* 218 Fed. 188;
Connecticut Mutual Life Insurance Co. v. *Eaton,* 218 Fed. 206;
Fuller v. *Metropolitan Life Insurance Co.,* 70 Conn. 647.

The laws of all the States require of every life insurance company as a condition precedent to the continued transaction business that its assets shall not be less than the legal reserve. The amount of legal reserve is calculated annually by the supervising commissioners, and by the companies, and is based on an assumed rate of mortality formulated from long experience and an assumed rate of income from invested funds conservatively estimated at a low rate.

Conservative companies maintain assets somewhat in excess of the "legal reserve", in order to meet contingen-

cies, such as a fall in the market value of securities, or an abnormal increase in mortality due to war and pestilence, both of which were experienced to an unusual degree in connection with the late war. This margin of safety over reserve requirements is called a "contingent reserve" and the amount of it is in the discretion of the directors based on experience and forecast. These two reserves—one required by law, the other discretionary—comprise the entire assets of the respondent which are held for investment and are invested under statutory restrictions in government, municipal, railroad and utility bonds, bonds secured by mortgages on real estate, loans on collateral and to policyholders and the necessary office building. The average rate of interest on respondent's invested assets is and for many years has been less than six per cent. per annum (R. 2).

Respondent's assets are not segregated or earmarked or specially allocated to either of these reserves. Nor are they separately invested. There is no requirement of law or sound practice that requires such allocations, nor is it practicable in view of the fluctuating market value of the assets, which would require a constant shifting of assets from the legal reserve to the contingent reserve and *vice versa*. The assets, therefore, constitute one general fund. The interest earned on all its securities, except those which because of their character are specifically exempt from tax, is included in respondent's return of income for federal income tax purposes (R. 3).

The calculation of premium rates for life insurance involves first, the adoption of a table of mortality showing the estimated death rate for each age of life; second, the

adoption of an assumed rate of interest such as the Company may safely expect to realize upon its invested assets during the lifetime of the policy. These two factors determine what is technically known as the net or mathematical premiums, which are the sums sufficient to pay all outstanding policies as they become claims, provided deaths occur exactly in accordance with the table of mortality, and the rate of interest earned on the investment of such premiums is exactly equal to the interest rate assumed. To the net or mathematical premiums there is added a sum technically known as "loading" for the purpose of meeting the expenses of conducting the business as well as any unforeseen contingencies, such as an abnormal death rate due to war or pestilence. The net or mathematical premiums, increased by the "loading", constitute the premium rates stipulated in the policies of insurance.

Premium rates so computed, are, in the experience of life insurance companies, generally found to be in excess of their requirements. In a mutual company such excess constitutes its margin of safety and should be liberal. Such a company has no capital stock and must rely entirely upon its premiums as the contributions of its members, invested in its business, and available to meet unusual contingencies. These contributions must be sufficiently large to give protection and they also constitute a fund of the members for the purpose of investment. The policies of the company may run for a period of fifty or even seventy-five years and the stipulated premium cannot be increased after the policy is issued. In computing their rates the companies use, therefore, a table of mortality showing an admittedly higher death rate than that which will probably be realized. Policyholders are selected from an examined class of risks.

The assumed rate of interest on investments is also lower than that which the company expects to realize. The provision for expenses and contingencies is greater than would ordinarily be required. Mutual companies have these three margins of safety and normally, and in accordance with expectation, each assumption is in excess of what is actually required.

At the end of each year the excess of receipts over disbursements is ascertained, and after setting aside so much of such excess as is required by the increase in policy reserves and other provisions, including the contingent reserve, the balance is held for refund to the policyholders. Each policyholder's share in this sum is then ascertained, and, before his next premium falls due, he is advised of the amount of the refund of premium due him and that the Company will accept in full settlement of his next premium the difference between the premium written in his policy and the amount of this refund.

In the instant case the calculation of the legal reserve, as shown in the schedules annexed to the complaint, is on the basis of the American Experience Table of Mortality and three per cent. interest. But, as already stated, the actual mortality would be less than that thus estimated and the return on investments will normally be more than three per cent. So that in fact the legal reserve, apart from the contingent reserve, always represents much more than the amount sufficient upon reasonable expectations to meet all outstanding risks.

While the corporation continues its business, the assumption is, as borne out by the experience upon which the corporation bases its calculations, that the premiums re-

ceived in a given year with the earnings on investments will always be more than the amount necessary to cover the claims which mature during the year on the outstanding policies as well as the amount which may be required for proper reserves.

In a continuing business, with policies maturing, or surrendered, and with new policies issued, it is the expectation, and experience shows that it will be the result in a business conducted on such calculations as have been described, that the reserve will always be intact. It is true that as policies mature or are surrendered, the assets said to compose the reserve with respect to such policies, need no longer be regarded as reserved, and, on the other hand, each year from the amount received as premiums and interest additions are made to the reserve. The net addition to the reserve in any year is, of course, determined after allowing, or deducting, the amount no longer required to be held in reserve with respect to policies matured, or surrendered, and discharged in that year. But the premiums received in each year with the interest on the investment is expected to be sufficient to pay all the amounts payable on policies in that year and to provide the required addition to the reserve.

It would be a most extraordinary situation in which the legal reserve of a mutual life insurance company properly conducted on a level premium basis would be impaired. For example, in this case, we have, as an admitted fact, the yearly net additions to respondent's reserve, shown in Schedule F annexed to the complaint (R. 3, 10). These yearly net additions appear from the year of the respondent's incorporation, that is, 1845, to and including the year 1917. Thus, we have a history of the reserve of the re-

spondent for about seventy-two years. On examining this record (R. 10) we find the amounts carried to reserve from premiums and from interest each year, and the total reserve at the end of each year. It will be observed that this total reserve which the company has maintained has increased from $20,252.63 in 1845 and 1846 to $200,815,927 at the end of 1917. It will also be noticed that the amount of the reserve at the end of each year was always greater than it was the year before, except in the years 1861 and 1862 when there was a reduction of the reserve; in 1861, of about two per cent., and in 1862, of less than ten per cent. In all the other years the reserve at the end of each year was greater than it was at the beginning of that year.

Thus, with the exception of two years in the Civil War, the assets constituting the legal reserve of the respondent have been, as according to its calculations they were intended to be, a permanent fund with annual increments and not diminished either by the payment of policies maturing in each year or by the expenses of each year.

On January 1, 1917, the respondent's legal reserve was computed at $186,258,796. Of this sum, about $70,000,000 consisted of premiums paid in by its policyholders and about $116,000,000 consisted of interest earned by its invested funds.

The legal reserve considered as a fund consists simply of assets, intended to be permanently invested in the enterprise from which an income is annually derived for the corporate purposes.

This fund, we submit, is a capital investment.

In *Penn Mutual Co.* v. *Lederer*, 252 U. S. 530, 534, this Court said:

"On the other hand, the service performed in level-premium life insurance is both protection and investment. Premiums paid—not in the tax year, but perhaps a generation earlier—have earned so much for the coöperators, that the company is able to pay to each not only the agreed amount but also additional sums called dividends; and have earned these additional sums, in part at least, by transactions not among the members but with others; as by lending the money of the coöperators to third persons who pay a larger rate of interest than it was assumed would be received on investments. The fact that the investment resulting in accumulation or dividend is made by a coöperative as distinguished from a capitalistic concern does not prevent the amount thereof being properly deemed a profit on the investment. Nor does the fact that the profit was earned by a coöperative concern afford basis for the argument that Congress did not intend to tax the profit."

If a mutual life insurance company which has thus maintained such a legal reserve, decides to terminate its business then, of course, its assets, the company being a mutual one, will be treated on liquidation as belonging to the members who have contributed them, and these members will receive their appropriate shares or proportionate interests. These shares or interests are not in the nature of matured claims on policies. If there are such matured claims, those who hold them would, in the process of liquidation, be entitled to be paid first before the distribution among the members, that is, among the policyholders who had not withdrawn from the company and whose policies had not matured.

Mayer v. *Attorney General*, 32 N. J. Eq. 815.

From these considerations, it appears:

(1) **The title to the assets which are equal to, or are said to compose, the legal reserve is in the corporation.**

The rights of members of a mutual life insurance company are determined by the contract of membership. The rights and title of members in a mutual life insurance company are as distinct from the rights and title of the corporation, as the rights and title of stockholders are distinct from the rights and title of the corporation having capital stock.

The assets which are said to compose the legal reserve are not segregated. The title to these assets, that is the ownership, is just as completely in the corporation as the title or ownership of any other assets. When it is said that the assets of a mutual life insurance company belong to its members, it is meant that they belong to the members in the sense that in a stock company, the assets belong to the stockholders (*Mayer* v. *Attorney General,* 32 N. J. Eq., 815, 822). As members, the policy-holders manage the business through their agents, the directors, whom they exclusively have the power to elect (*id.,* p. 820). In stock corporations, the stockholders have that right; in a mutual company, the policy-holders, as the members of the corporation (*Penn Mutual Co.* v. *Lederer,* 252 U. S. 523, 535). But neither the stockholders in the one case, nor the members of the mutual company in the other case, have title to the assets of the corporation, either in law or in equity.

(2) **The legal reserve is not "money or other property borrowed".**

The assets equal to, or composing, the legal reserve are derived from premiums and the increment is obtained

through investment. The premiums are not borrowed and the increment is not borrowed. The premiums are paid under a contract by which they constitute contributions by the members of the corporation. The corporation enters into a certain engagement; but this engagement does not involve an obligation to pay back the premiums. The undertaking of the corporation is to pay a given sum on a given event. When the event happens, and not before, the company must pay. Until it happens, the undertaking is a contingent one; the contingency may never happen. If the policy is for a definite term, it is payable in case of death within the term. If it is an ordinary life policy, it must be in force when the death occurs, and, in the meantime, the premiums must be paid.

On the maturity of the policy, whether for a term or for life, the amount payable by the company is fixed by the policy and is not the amount of premiums which have been paid. In Schedules D, E and F annexed to the complaint to show the methods of calculating the reserve (R. 8 and 9) the illustration is given of an ordinary life policy of $1,000 issued at the age of thirty-five. It appears that at the end of the first year, although the policy is for $1,000 the reserve is only $12.88; at age forty, the reserve is only $82.94.

The policyholder, while he continues a member of the corporation, has no right to withdraw any part of the reserve. This is admitted (R. 4, par. 7). On ceasing to be a member of the corporation and surrendering his policy for cancellation, he may, ordinarily, at his option, receive a certain sum in cash or in paid-up policy in reduced amount or extended insurance for the full amount of the limited period. Any allowance thus made is never in ex-

cess of the reserve. It is generally less, and in some circumstances no allowance at all is made. This is also admitted (*id.*). No interest is paid upon the premiums contributed. No action for the recovery of these premiums can be maintained by the members.

It thus appears that there is no obligation on the part of the corporation to repay the amounts paid in as premiums. The premiums cannot be treated as money borrowed. The assets equal to, or composing the legal reserve, derived from premium payments and the invested funds are not money or property borrowed.

(3) **The fact that the reserve in question is required by law does not alter the quality of the assets which compose it.**

There are requirements of laws that corporations engaged in certain businesses shall have a stated amount of capital. There are legal provisions requiring deposits of securities with state officers. These requirements are intended to afford security to those who deal with the corporations. The funds thus maintained are to give assurance of safety. But the fact that these funds are thus required and maintained does not deprive the assets which constitute them of the quality of capital. On the contrary, they are subscribed, contributed and maintained as capital for the very purpose of complying with the law and giving the necessary foundation for the business undertaking.

It is of the essence of capital that it is the basis of the enterprise. It is the presence of capital that gives security. Certainly the fact that there are assets which afford protection and security does not deprive them of the characteristics of capital.

What should be the capital in a given enterprise, what amount should be required by law, in case of a public interest demanding such supervision, to be invested in the enterprise in order to afford security or a proper basis for the conduct of the business, depends upon the nature of the business, upon the engagements contemplated in the business, upon what experience shows to be needed for the safe conduct of the enterprise.

The point is that what the law requires is not the less capital simply because the law requires it.

(4) **The legal reserve is not an indebtedness.**

As the corporation is not bound to refund the amounts paid in as premiums, as these amounts are not borrowed money, as the corporation does not owe these amounts, the portion of the assets, derived from these premiums, which is held in reserve, cannot be regarded as an indebtedness. The corporation does not *owe* the premiums to anybody, and, of course, it cannot be said that the corporation *owes* the amounts earned by the investment of the premiums to anybody.

The corporation has made its agreement in its policies. But this agreement does not constitute either the premiums or the increment through investment on the premiums an indebtedness. And as the reserve is made up of these, the reserve is not an indebtedness.

It is urged that the legal reserve is carried by the companies as a liability; that it appears on the liability side of the ledger. But so is capital stock in the case of a corporation having capital stock. So is surplus. The principles of bookkeeping require that assets be balanced by corresponding entries on the liability side. The fact that

the legal reserve may be carried in accounts or reports as a liability does not mean that it constitutes an indebtedness. It does not mean that it is in a different legal category from contributions to capital which are always carried as liabilities.

The Government urges that the legal reserve is a "present existing liability." If so, someone must be able to enforce it. But there is no member, or policyholder, of the respondent who has any such claim. The respondent has been in business since 1845, but its legal reserve has been intact and constantly increasing; it has grown, as already pointed out, from $20,000 to over $200,000,000. During all these years, there never has been any person entitled to recover any part of it. Policy-holders have come and gone; they have been born, insured and died, but not one of them has ever had a cause of action for any part of the reserve. The respondent has never owed any part of the reserve to any one of them. The reserve has always been a permanent fund, contributed to, increased and maintained as such, which has enabled the policy-holders, members of the corporation, to feel perfectly secure—not because they were entitled to receive any part of the fund, but because the foundation of the business was unimpaired, and so long as the business continued without some very extraordinary loss, (of a sort not encountered in over 80 years) the company would be able to pay its losses on policies, or matured claims, each year out of the moneys received in that year, while at the same time, as against all contingencies, the basis of the enterprise would remain in a volume of assets which abundantly secured it.

The Government seems to argue that because death is certain the legal reserve of a mutual life insurance com-

pany is a present existing liability. But the policyholder in the case of an ordinary life policy must keep his policy in force in order that the amount payable on death may be recovered. If he withdraws from the company or surrenders his policy, what he generally receives is less than the reserve and in some cases he receives nothing (R. 4).

It is strikingly inaccurate to say that the reserve constitutes a "present existing liability".

The fact that there are assets in hand to meet emergencies does not mean that these assets are not capital. In fact, it is of the essence of capital to meet emergencies. It is contributed for this very purpose. In businesses where the public interest seems to demand it, capital is required in order that contingencies may be met.

Where a corporation, like an insurance corporation, receives large amounts of money from the public, it has been regarded as sound public policy to require the company to hold assets which will constitute the enterprise a safe one at all hazards. But it does not follow that the assets thus acquired by a corporation constitute an indebtedness, or that the amounts which it thus receives, owns and invests, and for which it is not indebted, does not constitute invested capital.

The question in the present case is whether the reserve constitutes an indebtedness. It is composed of assets owned and held for investment. These assets are contributed, not lent, to the corporation. They are contributed by the members. None of these members or policyholders has any cause of action to recover them.

We submit that no amount of discussion can alter the fact that the reserve consists of assets and not debts. Matured policies are claims. All that the respondent owes are

taken care of before we come to consider the assets in question. These assets are accumulations, which are reserved, not owed. They are balanced in the ledger by the reserve, but only after all indebtedness has been separately debited.

(5) The fact that several States, including New Jersey, tax life insurance companies only on the excess of their assets over their legal reserves does not make these reserves an indebtedness.

This practice is a special statutory concession to insurance companies in order to avoid what would otherwise be oppressive taxation deemed to be opposed to the public interest.

Thus, in *People's Fire Insurance Company* v. *Porter*, 35 N. J. Law 575, 579, 580, the Court said:

> "The Act of March 24, 1864, which relates to corporations whose business is that of insurance on lives, is a peculiar statute, for a favored class, and the allowance of deductions of the present value of policies, as a part of the liabilities of such companies, is distinct from the claim here made for allowance and deduction of what are called unearned premiums. It is certainly an exception from the general policy of the statute in taxing private corporations."

And in *Newark* v. *State Board of Taxes*, 81 N. J. Law 416, 421, the Court said:

> "The right given by the statute to the company, to deduct from the amount or value of its property the amount of its liability on its policies, is, in its essence, a grant of exemption from taxation; and it is a fundamental rule in the law of taxation that such grants will never be permitted to extend, in scope, beyond what the terms of the concession

clearly require, and that all doubts as to the scope of the exemption must be resolved in favor of the state."

Some jurisdictions have held that the explicit language of the taxing statute exempted a sum equal to the required reserve. Other jurisdictions have held that these assets are not exempt from taxation. The rule is that in the absence of a statutory granting of exemption, the total sum of assets possessed by the Company is subject to the tax.

In *Sun Mutual Life Insurance Company* v. *Mayor,* 8 N. Y. 241, a mutual insurance company was authorized to accumulate a fund which should be liable for losses during the term of its existence. The company was held liable to taxation upon the capital so accumulated. The Court said:

> "The statute under which the plaintiff organized, provides, that when applications to the amount of $500,000 shall be received, trustees may be chosen, that premiums paid in the first instance shall constitute the assured stockholders, and shall never be withdrawn from the company. This fund, although permanent and liable for all losses and expenses of the corporation during the continuance of its charter, is not, it is said, capital, because it was not constituted with a view to profit, but as the price of indemnity; capital, we are told, being money invested in business, with a view to profit. * * * The answer to it is, that the premiums are advanced by the persons seeking insurance with a view both to indemnity and profit.
>
> "By the payment of the premium the assured is entitled to indemnity and the same act constitutes him a stockholder, and in that capacity he acquires a new interest in the fund he has parted with, for a

full consideration. The money becomes capital to the company of which he is a member, to be used in sustaining its credit in paying losses, in investment by way of loan, the proceeds of which are ultimately to be divided among the stockholders.

"Again, it is said that the profits are not capital, and therefore cannot be taxed as such. This may be conceded as an abstract proposition, but the appellants must go farther and prove that profits cannot be made capital, either by contract or the act of the legislature, * * * and in the case before us the legislature has provided for an accumulation to the amount of $500,000; and, in addition, the agents of the corporation, in 1846, determined by a formal resolution, as they rightfully could do, that no division of the profits should be made until the accumulated earnings should exceed one million of dollars. These accumulations became capital, and liable for all debts of the corporation. * * * Under the old system, the capital was paid in, in whole or in part, by a time designated. In mutual companies, on the contrary, contributions may be made, from time to time, to the capital; and an interest, not merely derivative but original, acquired in it, so long as they continue to transact business."

In *People* v. *Board of Supervisors of New York,* 16 N. Y. 424, a mutual life insurance company was authorized by its charter to accumulate from premiums received and from the profits of their investment a fund to continue liable for its losses during the term of its existence. It was *held* that the accumulation of premiums and profits made by the company was capital within the provisions of statutes taxing corporations.

In *People ex rel. National Surety Company* v. *Feitner*, 166 N. Y. 129, it was *held* that a fund described as a reinsurance reserve required by law, being the amount necessary to reinsure outstanding risks which had become the absolute property of a company guaranteeing the fidelity of persons holding positions of trust, without any liability on its part to return any portions of the premiums paid, and subject only to liabilities which might arise from outstanding contracts, did not represent an indebtedness of the company which could be deducted for the purposes of taxation. The Court said (p. 135):

> "While it is apparent that the relator has not in fact 'just debts owing by' it equal to fifty per cent of the unearned premiums, our attention is nevertheless invited to that portion of the General Insurance Law under which relator is organized, which provided the method by which the solvency or insolvency of a company is determined, and the point is made that for that purpose at least 'a sum equal to the total unearned premiums on the policies enforced' must be charged as a liability. True; and it also requires that for such purpose the capital stock shall also be charged as a liability. But it will not be claimed that the capital stock may be treated as a debt to be deducted from the company's assessable assets on that account, and of course no stronger argument can be made in support of a claim that the statute intended to have unearned premiums that are really an asset of the company treated as a debt for the purposes of assessment."

In *Republic Life Ins. Co.* v. *Pollak*, 75 Ill. 292, it was held that the reassurance reserve and premiums of life insurance companies being collected are subject to taxation as

they are claims and funds that would be taxable in the hands of a natural person.

In *City of Portland* v. *Union Mutual Life Ins. Co.*, 79 Me., 231, it was held that under a statute making all personal property with certain exceptions taxable to the owner in the town where he is an inhabitant, a mutual life insurance company is legally taxable, in the town where its principal place of business is, for the stocks, bonds and other securities or personal property in which its funds and annual earnings have been invested. And such earnings and the premiums received from its policy holders were not considered as "personal property placed in the hands of the corporation as an accumulating fund for the future benefit of heirs or other persons," and, therefore, are not within the exceptions named in the statute. The Court said:

> "The contract of life insurance is not a deposit of the premiums to be paid to some person with their accumulations at some future time, but a special contract of hazard for the payment of a sum stipulated without regard to the amount paid in premiums before the happening of the contingency."

The case of *Kansas Mutual Life Association* v. *Hill*, 51 Kans. 636, 33 Pac. 300, held that the reserve fund of a mutual life insurance company organized on the cooperative plan and having no capital stock was subject to taxation. The court specifically decided that the reserve of such an insurance company was not an indebtedness which it was entitled to deduct from the credits of the company subject to taxation. The Court said:

"The general rule is, that all property must bear its share of taxation, unless expressly exempted therefrom. There are no stockholders in this company to be taxed on their stock. No policyholder has a fixed right to any definite portion of the funds of the company. The ownership of all its assets of every kind is in the company alone. It is true that it has contingent liabilities, and is, in a sense, a trustee of the funds in its possession, but the beneficiaries of the trust are not yet determined except as to the $10,000 of losses already accrued. Each and any of the policyholders may forfeit their rights in the fund by failure to pay their assessments, and many of them probably will. A contingent liability which is not susceptible of computation is not a debt owing in good faith which may be deducted from credits under the tax law, and we fail to find anything in the statutes indicating that it was the intention of the legislature that the reserve fund of an insurance company should be exempted" (pp. 649-650).

In *Commonwealth Life Ins. Co.* v. *Louisville,* 145 Ky. 284, 140 S. W. 306, the Kentucky Court of Appeals held that securities deposited with a State Treasurer by a life insurance company for the benefit of policyholders and as a condition of its doing business in that state, were taxable locally on the ground that they belonged to the company, and that the policyholders had no lien thereon.

The Court said:

"* * * They are not deposited with the State Treasurer to the credit of any particular policyholder, nor has any particular policy-holder any claim to any of them above that of all other policyholders. When the company comes to pay a policy

> or give a policy-holder the net cash balance of his policy, it does not necessarily raise the sum to be paid from the securities deposited with the State Treasurer. In the ordinary course of its business, it satisfies the policy-holder out of other funds in its possession. * * * The securities on deposit with the State Treasurer are not liable for the debts of the company to a greater extent than is any other property owned by it. So far as its liabilities are concerned, all of its property occupies the same position. It is all charged with the payment of liabilities" (p. 288).

And in distinguishing between such deposits of securities and deposits in a bank, the court said:

> "But the attitude of an insurance company towards the securities placed by it with the State Treasurer is very different from the attitude occupied by the bank towards its depositors. The securities on deposit with the State Treasurer before they are deposited belong absolutely to the insurance company, subject to the payment of its debts. They continue to be its property subject to the payment of its debts. At no period, has the policyholder any interest in these securities, except to the extent that they may be necessary to satisfy the conditions of his policy. At no time can the policyholder demand that any of these securities shall be turned over to him, or sold for his benefit, unless it should be that the company was in process of liquidation."

In many jurisdictions the reserve is not treated as a liability for purposes of local taxation; in the cases cited by the Government, it is only so treated by special provision of law as an appropriate concession to the business of life insurance; and it is, therefore, submitted that this conces-

sion should not be a precedent for a ruling adverse to insurance companies in applying a statute defining capital for the purposes determining whether they have made excess profits through the war.

(6) **The legal reserve is not a trust fund.**

Many years ago the doctrine was laid down that the assets of a corporation were a trust fund for the benefit of its creditors. But, of course, this did not mean that the creditors in the case of a solvent corporation were *cestuis que trustent.* In the case of an insolvent corporation it meant substantially that the creditors' rights were superior to those of the stockholders. Of course, the policyholders of a mutual life insurance company are members, not *cestuis que trustent.* They have rights under their policies, but the company is not a trustee and the assets of the company are not trust funds. If it is meant that directors, the agents of the members of the corporation, must perform their duties under the law, or that in case of liquidation there must be an equitable distribution, there is no objection to the doctrine, but it in no way alters the fact that the assets in question belong to the corporation and have been contributed for investment in the business and constitute a reserve having the characteristics of invested capital.

The contention that the relationship of a mutual company to its policyholders is that of trustee has not found favor with courts, and is expressly disapproved in *Equitable Life Assurance Society* v. *Brown,* 213 U. S. 25 (1908).

> "They lay no foundation for the jurisdiction of a court of equity in such a case, unless it appears that the relation between the policyholder and the defend-

ant is that the latter is the trustee of the former by reason of the trust relation between them resulting from the insurance policy. The complainant's contention, as above stated, that there is such a trust in the fund mentioned has never been regarded as the law in the State of New York (*Cohen* v. *New York Life Insurance Company,* 50 N. Y. 610; *People* v. *Security Life &c. Co.,* 78 N. Y. 114; *Bewley* v. *Equitable Life &c.,* 61 How. Pr. 344; *Uhlman* v. *New York Life Ins. Co.,* 109 N. Y. 421; and, to the same effect, *Greeff* v. *Equitable Life Assurance Society,* 160 N. Y. 19), nor anywhere else so far as any case has been cited on the subject.

"In the *Uhlman case, supra,* the plaintiff was the owner of a policy known as a ten-year dividend system policy, otherwise a 'tontine plan' policy, which, it was averred, gave to the holder a special title to the funds derived from the payment of premiums on the policies of that kind and in the particular class to which the policy belonged. The Court of Appeals of New York held that such claim was not well founded; 'that it could not be said that the defendant is in any sense a trustee of any particular fund for the plaintiff, or that it acts as to him and in relation to any such fund in a fiduciary capacity. * * *' " (p. 46).

See, to the same effect:

Peters v. *Equitable Life Assurance Society,* 200 Mass. 579;

Equitable Life Assurance Society v. *Weil,* 103 Miss. 186;

Townsend v. *Equitable Life Assurance Society,* 183 Ill. App. 326;

Gourley v. *Northwestern Mutual Life Ins. Co.,* 94 Okla. 46.

THIRD. The assets equal to, or composing, the legal reserve are not within the non-inclusion clause of the statute.

The non-inclusion clause of Section 207 is as follows (40 Stat. 306):

> "As used in this title 'invested capital' does not include stocks, bonds (other than obligations of the United States), or other assets, the income from which is not subject to the tax imposed by this title, nor money or other property borrowed."

It has already been shown that the assets which are equal to, or said to compose, the legal reserve are not "money or other property borrowed."

The remaining question then relates to "stocks, bonds (other than obligations of the United States), or other assets, the income from which is not subject to the tax imposed."

(a) On December 31, 1916, the respondent had state and municipal bonds to the extent only of $4,171,901.33 and stock amounting to $17,250 (R. 7, Schedule B, annexed to complaint). It is manifest that a deduction of these amounts from the total invested assets would not reduce the invested capital so as to subject the respondent to the war excess profits tax.

(b) The inquiry then relates to "other assets, the income from which is not subject to the tax imposed by this title."

But the respondent has no such "other assets". We do not understand that the Government contends otherwise, but if it does, the argument is untenable.

The test as to the non-inclusion of any given asset is whether *the income from it* is excluded from the net income of a corporation as defined by Section 206 (40 Stat. 305) which provides that the net income should be ascertained and returned for the taxable year upon the same basis and in the same manner as provided in the Act of September 8, 1916 (39 Stat. 756) "except that the amounts received by it as dividends upon the stock or from the net earnings of other corporations, joint stock companies or associations, or insurance companies, subject to the tax imposed" by Title I of the Act of 1916 "shall be deducted". This exception does not apply.

We are thus referred to the Act of 1916 to determine what are the assets the income from which is not subject to the tax imposed by the Act of October 3, 1917. Section 4 of the Act of 1916 (39 Stat. 758) provides that the following income shall be exempt from the provisions of this title:

> "The proceeds of life insurance policies paid to individual beneficiaries upon the death of the insured; the amount received by the insured, as a return of premium or premiums paid by him under life insurance, endownment, or annuity contracts, either during the term or at the maturity of the term mentioned in the contract or upon the surrender of the contract; the value of property acquired by gift, bequest, devise, or descent (but the income from such property shall be included as income); interest upon the obligations of a State or any political subdivision thereof or upon the obligations of the United States

> or its possessions or securities issued under the provisions of the Federal farm loan Act of July seventeenth, nineteen hundred and sixteen; the compensation of the present President of the United States during the term for which he has been elected, and the judges of the Supreme and inferior courts of the United States now in office, and the compensation of all officers and employees of a State, or any political subdivision thereof, except when such compensation is paid by the United States Government."

It is apparent that the income derived from the respondent's assets in question, is not exempted income under this provision.

All the income from respondent's investments (other than that from United States, State or municipal bonds) has been treated as gross income for the purpose of the income tax. After the statutory deductions, the tax is paid on the balance.

In determining net income, Section 12 (a) (39 Stat. 768) provides that in the case of an insurance company there may be a deduction from the gross income as follows:

> "Second. * * * (c) in the case of insurance companies, the net addition, if any, required by law to be made within the year to reserve funds and the sums other than dividends paid within the year on policy and annuity contracts."

Under this provision the respondent, in making its income tax return for the year 1917, deducted the amount of its payments on policies ($20,669,808.48) and its net addition to the reserve fund ($14,557,131).

These deductions do not bring the assets in question within the non-inclusion clause of Section 207 for the determining of invested capital.

The net addition to the reserve fund made in the year 1917 was not chargeable either by the law or in practice against the income from any particular fund. And, as Judge Rellstab observed (R. 32) "the net additions made in 1917 are not part of the legal reserve which the plaintiff seeks to have allowed as invested capital. This reserve is made up solely of net additions of preceding years."

According to the language and spirit of the Act, it is the *character* of the assets, and not the *use* to which the income is put, which determines whether it shall be excluded from invested capital. This is made plain by the context. The clause reads "stocks, bonds (other than obligations of the United States), or other assets the income from which is not subject to the tax," showing that it is the *source* of the income which is determinative. It is only when the income is derived from an exempted source that the exception applies. But, save with respect to State and municipal bonds, stocks, and the express exemptions of Section 4 of the Act of 1916, the income derived from the assets composing the legal reserve of an insurance company is not exempted.

The provision of Section 12 (a) of the Act of 1916 for the deduction of the net addition to the reserve fund, has no relation whatever to the provision of Section 207 of the Act of 1917 with respect to invested capital and to what should not be included therein.

To repeat, the assets composing the reserve fund, are not assets the income of which is not subject to the tax imposed, unless these assets are United States, State or municipal bonds or come within the provision which exempts them, above quoted. In the case of the respondent there were no assets which could be allocated to the legal reserve in question (save the United States, State and municipal bonds and the small amount of stock which was owned) which could be regarded as assets the income from which was exempt.

If the reserve is to be excluded from invested capital because earnings therefrom might conceivably be considered as making up a part of the net addition to the reserve, which is deducted from the gross income, it would be necessary, on the same principle, to deduct from invested capital such part of the assets, the income from which would equal the expenses of management, likewise deductible from gross income; and also a further portion of the assets, the income from which would be sufficient to equal the taxes paid which are deducted from gross income; also, funds sufficient to earn income equivalent to the $3,000 specific exemption provided in Section 203(a). This would be absurd. There is neither in the law nor in the practice of insurance companies any special allocation of assets to the various items deductible from gross income in determining the earned income tax.

If it be urged that in the calculations of life insurance companies it is assumed that the invested funds earn interest which is added to the reserve, it must be remembered that the statutory ascertainment of the reserve only assumes a three per cent. return, while, in fact, the plaintiff's investments yield about five per cent., so that even on

this theory at least a part of the income from invested reserves goes into net income for the purpose of the ordinary income tax.

The reserve is merely a yard-stick to determine whether the company has an appropriate basis for the conduct of its enterprise. The assets which are said to compose the reserve are the company's property, representing either cash paid in, or paid in or earned surplus and the income from all of these assets is returned as gross income for the purpose of the tax.

While the net additions to the reserve in the taxable year are deductible from the gross income of that year, these net additions form a part of the assets of the company held for investment, the income from which is the subject of the income tax in the ensuing years. So that while the net additions in each taxable year are deductible from the gross income of that year, the reserve itself as a continuing and increasing fund is always an investment the income from which is subject to the income tax.

Judge Rellstab called attention to the fact that whatever might be said as to the net additions to the reserve beginning with the year 1909, when the Federal Excise Tax on Corporations was adopted (36 Stat. 112), it could not by any possibility be said that the reserve which had been accumulated prior to that time constituted assets upon which an income tax had been in any sense escaped, for there was no such tax. Judge Rellstab pointed out that at the beginning of the year 1909 the total legal reserve was the sum of $110,124,750.07, and the interest derived therefrom was subject to the Federal income tax in that and subsequent years. He also observed that of the total re-

serve held on January 1, 1909, the sum of $33,569,887.14 was contributed from premiums and that this sum was an aggregate cash contribution by the members of the respondent to be used and employed by it in its business of life insurance.

Judge Rellstab also noted that the New Jersey Legislature first required life insurance companies to maintain a legal reserve in the year 1872; and that at the beginning of that year respondent's reserve amounted to the sum of $19,656,144 and that this sum, if added to the amount allowed by the Government as invested capital ($14,719,043.76) would bring the total of invested capital above the sum of $25,500,000, an amount concededly sufficient to avoid the imposition of any excess profits tax for the year 1917 (R. 36; 295 Fed. pp. 892, 893).

There is another point which in any view would seem to be controlling. The net addition to respondent's reserve during the year 1917 was $14,557,131. Of this sum $6,220,570 were derived from interest received in 1917 on the assets held at the beginning of the year and $8,336,560 from premiums received during the year (R., Schedule F, p. 10). The interest received by the respondent in 1917 amounted to $10,130,857 (R., Schedule C, p. 8). Only 61.402 per cent. thereof, or $6,220,570, was required for the addition to the reserve in 1917; the balance $8,336,560, as shown above, came from premiums received in 1917.

In imposing the tax in question, the Government based the amount of respondent's invested capital at the beginning of the taxable year, before making any deductions therefrom, at $201,486,566.

We have shown that all the assets of respondent, which can be said to compose the reserve, are subject to the income

tax (with few immaterial exceptions), and hence that there is no part of the reserve which falls within the non-inclusion clause. But, we submit, that if the Government could be justified in making any deduction from invested capital because of the provision that the addition to the reserve is deductible, the Government on any theory could not justify the deduction of any larger sum than an amount which could be said to earn the interest thus said to be exempt for the reason that certainly the interest earned on the rest of the assets was subject to the income tax.

It follows, therefore, that even under the Government's claim, all that could be excluded from invested capital would be 61.402 per cent. of the total assets of $201,486,566 which would be equivalent to $123,716,781, leaving $77,769,785 as respondent's minimum and indisputable invested capital for the purpose of the Act.

Taking seven per cent. thereof as the minimum deduction allowed by the Act, the respondent was entitled to an income of $5,443,885 before any war excess profits tax could be assessed. And as respondent's net income, as adjusted, was only $1,781,815, it is evident that on any possible view it would not be subject to any war excess profits tax.

FOURTH. The Government's claim is not aided by the capital stock tax act of 1916, but, on the contrary, the provisions and policy of that act support the respondent's contention.

The capital stock tax act of 1916 (39 Stat. 789) provides for the payment of a special excise tax for the privilege of carrying on business by corporations including insurance

companies. The Act specifically exempted the assets which constituted the legal reserve of insurance companies from this tax. Section 407 of that Act is as follows:

> "Provided, that in the case of insurance companies such deposits and reserve funds as they are required by law or contract to maintain or hold for the protection of, or payment to, or apportionment among, policy holders, shall not be included."

The fact that in this Act the Congress specifically exempted the reserve from the provision of the excise tax indicates that the Congress thought that in the absence of such a specific exemption the reserve would be taxable. The failure of the Congress to exclude these assets which constitute the legal reserve from the definition of invested capital in the subsequent Act of 1917 shows clearly that there was no intention that they should be excluded. It will be observed that in the Capital Stock Tax Act the Congress did not refer to the reserve as an indebtedness. The exclusion was a concession evidently made in view of the benevolent character of insurance companies and in order to prevent the imposition of an exorbitant tax.

The Government cannot, in any event, invoke the capital stock tax act to aid its contention here, as it is apparent that the purpose of Congress in the imposition of the capital stock tax was a different one from its purpose in the imposition of the war excess profits tax. In the *former,* Congress was imposing an excise tax predicated on the fair value of the shares of stock, taking into consideration all elements of value—market quotations, net worth of assets, earning capacity, good will and any element of value conceivable. In assessing this tax, the earnings were treated

as one of the bases of current value, and the capitalization as a preferential basis of fair market value. (See Regulations 38, as revised August 9, 1918, Appendix A, Art. 1.) In the *latter,* Congress was imposing an excise tax on the invested capital—cash paid in and earned surplus retained —predicated on the income history of the corporation during the pre-war period and currently, so that excessive profits due to war conditions could be reached.

These different objects could not result in identity of capital under the capital stock tax act and invested capital under the war excess profits tax act, as is clearly pointed out in the Federal regulations applicable to the two taxes. We quote from Regulations 64 of June 15, 1922 (Art. 15):

> "The fair value of the capital stock, as provided under section 1000(a) (1) of the Revenue Act of 1921, and invested capital under the excess profits tax provisions of the Revenue Act of 1921 are not necessarily the same.
>
> "For the purpose of capital stock tax the fair value of the capital stock is estimated, and is predicated on present values, including actual appreciation of property, whether realized or unrealized, and such intangible assets as good will, trade-marks, and patents to the extent reflected by the earning power, whereas, for the purpose of excess-profits tax, the invested capital is based upon the actual investment of the stockholders in the corporation, irrespective of the present value of its assets. In the case of the capital stock tax the fair value looks to the present net value of the assets, irrespective of the amount of the investment of the stockholders."

It is therefore evident that under the theory applicable, and the regulations applied, in the assessment of the capital

stock tax, the assets equal to the amount of the reserve from which a large part of the earnings of the corporation are derived would be included, if not expressly excluded. The specific exclusion was, as suggested above, probably intended to prevent exorbitant taxation of life insurance companies.

The policy of Congress in furthering the object of life insurance companies in furnishing insurance at cost is achieved by this construction. The reserve is excluded in the capital stock tax act, thus reducing the tax and the cost of insurance to the policy-holders.

The reserve is included in the definition of invested capital thus precluding the assessment of a war excess profit tax unless all of the assets have yielded an exorbitant income and the cost of insurance is thus reduced to the member policyholders.

FIFTH. There is no distinction, in respect to the question here involved, between the reserve of a life insurance company and that of a fire, marine or casualty company.

The Government admits that the reserves of other insurance companies are to be treated as part of the invested capital under the war excess profits tax act, and these reserves have been so treated (Regulations No. 45, Art. 870).

The Treasury regulation provides:

> "The like reserve fund of insurance companies other than life insurance companies may be included in computing invested capital."

What possible ground there is for thus discriminating between *"like reserve funds"* we cannot understand.

It is said that a building may never burn, but that everyone must die. But death alone is not sufficient to give a cause of action on an insurance policy; the policy must have been kept in force. The death must have occurred while it is in force. This may not be. The building may burn and the owner may let his life insurance lapse.

Many life insurance policies are for a term of years. A large percentage of life insurance policies, whether for a term or for life, are not continued in force. The reserves in both life and fire companies are built up from the premiums paid in, are both required by State regulation, and are determined with equal exactness, with similar penalties for deficiencies (See 2 Comp. Stat. N. J. 2854, 56, 59, Secs. 56, 62, 70).

The distinction between fire insurance business and life insurance business does not help the Government, but rather the respondent. For, as this Court has pointed out, "The thing for which a fire or marine insurance premium is paid is protection, which ceases at the end of the term. If after the end of the term a part of the premium is returned to the policyholder, it is not returned as something purchased with the premium, but as a part of the premium which was not required to pay for the protection; that is the expense was less than estimated" (*Penn Mutual Co.* v. *Lederer*, 252 U. S., pp. 533, 534). In this view, treating the reserve of a fire insurance company as held exclusively for protection the argument would be stronger rather than weaker that it should be excluded from invested capital. On the other hand, this Court has pointed out in the same case that in level-premium life insurance the object of the

payments of premiums is both protection and investment. To quote again:

> "On the other hand, the service performed in level-premium life insurance is both protection and investment. Premiums paid—not in the tax year, but perhaps a generation earlier—have earned so much for the coöperators, that the company is able to pay to each not only the agreed amount but also additional sums called dividends; and have earned these additional sums, in part at least, by transactions not among the members, but with others; as by lending the money of the coöperators to third persons who pay a larger rate of interest than it was assumed would be received on investments. The fact that the investment resulting in accumulation or dividend is made by a coöperative as distinguished from a capitalistic concern does not prevent the amount thereof being properly deemed a profit on the investment."

In the case of a life insurance company, there is no basis for holding that these funds held for investment are not invested capital. The ruling of the Government that the reserve in the case of other companies should be invested capital destroys the foundation of its position that the reserves of life insurance companies should not be regarded as invested capital.

It should also be noted that the Congress specifically exempted the reserves of both classes of companies from the capital stock tax act.

SIXTH. Statements made in the course of hearings before the Committees of Congress are immaterial.

Such statements fall in the same category as statements in debates (*Duplex Printing Press Co.* v. *Deering*, 254 U. S. 443). The statements to which the Government refers in its brief were not contained in Reports of Committees and were not made with the responsibility of those entrusted in either House with the carriage of the measure.

The respondent is not to be made subject to the war excess profits tax because one of its officers urged the Senate Committee to modify the existing language.

It does not appear but that Committees, and the Congress, believed that the apprehensions of the respondent were groundless. Indeed when the fear was expressed that the Internal Revenue Department might construe the Act as excluding the legal reserve from the definition of "invested capital", Senator James, one of the three members of the Sub-Committee of the Senate Finance Committee, said: "I do not think that theory is very well grounded" (Hearings before the Senate Sub-Committee of Finance 64th Cong. 2d Sess. H. R., 20573, p. 53), and the other two members, by silence, may be taken to have acquiesced in that Senator's view. The statement was not reported to the main Committee nor by it to the Senate, nor is it important that an amendment of the law was sought. The construction of the Government was immediately attacked and this suit was brought. It may easily be concluded that the Congress thought that no amendment was necessary. Such a belief would have been justified with respect to the re-

serves of other insurance companies, and it is more than probable that the Congress did not conceive that the Government would take such an inconsistent position as it has taken with respect to reserves of life insurance companies.

We ask that the judgment be affirmed.

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